Case Western Reserve Law Review

Volume 11 | Issue 2

1960

Problems of Nontaxable Dispositions

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Tax Problems Incident To the Disposition of Real Estate

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PROBLEMS OF NONTAXABLE DISPOSITIONS

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Various problems in the acquisition, ownership, and operation of real property have been reviewed in previous articles within this Symposium. Here considered are problems involved in its sale, exchange, or other disposition. Certain of these problems arise because of the special character of the owner or the purpose for which he holds the property. Others are not so limited. The present discussion will be confined to those involved in certain nontaxable dispositions.

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Aside from such transfers as by gift, contribution, or inheritance, transfers to, from, or between corporations (*e.g.*, upon organization, reorganization, and liquidation), and transfers to and from partnerships, there are essentially two classes of disposition of business real estate upon which gain or loss is not recognized for federal income tax purposes. One of these is the exchange of property for property of "like kind."[1] The other is involuntary conversion.[2]

"LIKE KIND" EXCHANGES

No gain or loss is recognized when property held either "for productive use in trade or business" or "for investment" is exchanged for property of "like kind" to be held "for productive use in trade or business" or "for investment."[3] In contrast to certain other nontaxable dispositions,[4] nonrecognition here is mandatory, not elective, and applies to both gain transactions and loss transactions.

Property held primarily for sale to customers, *e.g.*, by a dealer, is expressly excluded.[5] Except for this, the principle has a relatively broad application. Property held for productive use, *e.g.*, by a manu-

1. INT. REV. CODE OF 1954, § 1031.
2. INT. REV. CODE OF 1954, § 1033.
3. INT. REV. CODE OF 1954, § 1031(a).
4. See, *e.g.*, discussion of § 1033, p. 215 *infra*, relating to gain upon involuntary conversion.
5. INT. REV. CODE OF 1954, § 1031(a). But unproductive property held by one other than a dealer for future use or speculation is held for investment, not primarily for sale. Treas. Reg. § 1.1031(b)-1(b) (1956).

facturer, can be exchanged for other property to be held for productive use; property held for investment, *e.g.*, by a speculator, can be exchanged for other property to be held for investment; and property held for productive use can be exchanged for property to be held for investment, or vice versa.[6] This, of course, assumes that the property received is of "like kind" to that transferred in the exchange.

The phrase "like kind" refers to the "kind or class" of property. Thus, it does not include an exchange of real property for personal property or vice versa,[7] but does include, subject to certain qualifications, exchanges of real property for real property, or personal property for personal property.[8] "Like kind" does not refer to the "grade or quality" of the property. Thus, the existence or lack of improvements and differences in such attributes as size, use, and location are immaterial. Accordingly, improved land for unimproved land,[9] business real estate for a ranch,[10] and city property for rural land[11] are all "like kind" exchanges. However, a substantial difference in the extent of the interest received as compared to that transferred will prevent the exchange from being for property of "like kind." Thus, ownership in fee simple is not property of "like kind" to a lease of less than thirty years,[12] but is property of "like kind" to a lease of thirty years or more.[13] Similarly, fee ownership in land is property of "like kind" to perpetual water rights[14] but not to rights which are limited in time or extent.[15]

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6. Treas. Reg. § 1.1031(a)-1(a) (1956).

7. Oregon Lumber Co., 20 T.C. 192 (1953), *acq.*, 1953-2 CUM. BULL. 5 (fee ownership in lumber exchanged for right to cut lumber where latter was classified as personal property under local law).

8. While the rule is not entirely free from doubt, a number of cases hold that the determination of whether property is real estate or personal property for this purpose is controlled by local law. See, *e.g.*, Oregon Lumber Co., *supra* note 7; Commissioner v. Crichton, 122 F.2d 181 (5th Cir. 1941), *affirming* 42 B.T.A. 490 (1940), *acq.*, 1952-1 CUM. BULL. 2; Molloy, *Tax Free Exchanges of Property of Like Kind under Section 112(b)(1) of the Internal Revenue Code*, 37 VA. L. REV. 555, 574 (1951); Note, 56 COLUM. L. REV. 445, 446 (1956). The general subject of the effect to be given local law in federal tax matters is also discussed in Note, 72 HARV. L. REV. 1350 (1959).

9. George E. Hamilton, 30 B.T.A. 160 (1934); Treas. Reg. § 1.1031(a)-1(c) (1956).

10. E. R. Braley, 14 B.T.A. 1153 (1929), *acq.*, VII-2 CUM. BULL. 6 (1928).

11. George E. Hamilton, 30 B.T.A. 160 (1934); E. R. Braley, *supra* note 10; Treas. Reg. § 1.1031(a)-1(c) (1956).

12. May Dep't Stores Co., 16 T.C. 547 (1951), *acq.*, 1951-2 CUM. BULL. 3; Standard Envelope Mfg. Co., 15 T.C. 41 (1950). *Quaere* whether renewal periods properly may be counted for this purpose. Compare effect of renewal provisions upon the period over which lessee's improvements are amortizable, discussed at p. 190.

13. Treas. Reg. § 1.1031(a)-1(c) (1956); Century Elec. Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1952). But see Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2d Cir. 1959), *reversing* 26 P-H Tax Ct. Mem. 927 (1957), where transaction takes the form of a sale, and the sale price and rental are proper. The Internal Revenue Service has announced that it will not follow the *Jordan Marsh* case. T.I.R. 194, 4 P-H 1959 FED. TAX SERV. ¶ 55,160.

14. Rev. Rul. 749, 1955-2 CUM. BULL. 295.

15. Commissioner v. P. G. Lake, Inc., 356 U.S. 260 (1958) (limited oil payment for fee

No gain or loss at all is recognized where the exchange is *solely* for property of like kind. It should be observed that "solely" refers to what is received, not to what is transferred in the exchange. Thus, cash and nonqualified property transferred in the exchange do not disqualify the transaction from the viewpoint of the party who *transfers* the "boot."[16] A liability assumed by one party, or subject to which the property is taken, is treated as the equivalent of cash and, hence, "boot" received by the other party to the exchange.[17] From the viewpoint of the party who *transfers* the "boot," the exchange is *solely* for "like kind" property if "like kind" property is all he receives on the exchange.

From the viewpoint of the other party, the *receipt* of "boot" in addition to "like kind" property has important effects. If the value of the "like kind" property plus the cash or other "boot" received by him is less than his basis for the property transferred by him, the resulting loss is not recognized to any extent.[18] On the other hand, if the value of the property and "boot" received by him exceeds his basis for the property transferred by him, the resulting gain is recognized to the extent of the cash and other "boot."[19] Stated another way, the amount taxable is either the amount of the gain or the amount of the "boot," whichever is the lesser.

The basis of property received in "like kind" exchanges depends upon whether, and the extent to which, gain or loss is recognized to the taxpayer. Thus, where no gain or loss is recognized to him, the basis of the property acquired on the exchange is his basis for the property transferred by him plus any money paid by him, or minus (*e.g.*, where there is a loss) any money received by him.[20] Where "boot" is received and, hence, gain is recognized, the basis of the property acquired on the exchange is his basis for the property transferred by him plus the amount of gain so recognized, minus the

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ownership). *Cf.* I.T. 4093, 1952-2 CUM. BULL. 130, holding that an oil producing lease extending until exhaustion of the deposit is property of "like kind" to fee ownership in improved ranch lands. See generally Appleman, *Exchange of Properties of Like Kind in the Oil Business,* N.Y.U. 11TH INST. ON FED. TAX 273 (1953).

16. Treas. Reg. § 1.1031(a)-1(c) (1956); W. H. Hartman Co., 20 B.T.A. 302 (1930), *acq.,* X-1 CUM. BULL. 27 (1931). However, gain or loss may be recognized to the party who *transfers* the *non*qualified property on the exchange. Treas. Reg. § 1.1031(a)-1(a) (1956).

17. Where each party to the exchange assumes or takes the property subject to a liability of the other party, the regulations require that the liabilities be offset to the extent possible, and they treat only the net balance as "boot." Treas. Reg. §§ 1.1031(a)-1(c) (1956), 1.1031(d)-2 (1956) and *Examples. Cf.* last sentence of INT. REV. CODE OF 1954, § 1031(d).

18. INT. REV. CODE OF 1954, § 1031(c); Treas. Reg. § 1.1031(c)-1 (1956).

19. INT. REV. CODE OF 1954, § 1031(b); Treas. Reg. § 1.1031(b)-1 (1956) and *Example.*

20. INT. REV. CODE OF 1954, § 1031(d). Where, in addition to transferring "like kind" property, the taxpayer pays cash or otherwise transfers "boot," it seems clear that the amount of the "boot" must be added to the basis of the property given up on the exchange in determining the basis of the property acquired. I.T. 2615, XI-1 CUM. BULL. 112 (1932). Treas. Reg. § 1.1031(d)-1(a) 1956 fail to mention this.

amount of cash received.[21] Whenever several properties of "like kind" are acquired, the basis so determined is allocated among them in accordance with their respective fair market values.[22] However, where, in addition to property of "like kind," money or nonqualified property is received, a basis equal to the money and the fair market value of the nonqualified property is first allocated to such "boot," and only the remainder is allocated to the qualified property.[23]

Thus, the rules governing recognition of gain or loss upon, and the basis of property after, a "like kind" exchange are relatively simple and straightforward. The same cannot be said regarding the other class of nontaxable transactions herein discussed.

INVOLUNTARY CONVERSIONS

Involuntary conversion deals with situations where property is compulsorily or involuntarily disposed of for a consideration. This may occur when insurance proceeds are received on account of the complete or partial destruction of property, *e.g.,* by fire, storm, earthquake, or the like;[24] when compensation (including amounts awarded as damages to the residue of the property) is received because property is seized, requisitioned, or condemned by public authority or by a private concern having the power of eminent domain; or when property is sold or exchanged under threat or imminence of seizure, requisition, or condemnation.[25] Different rules apply depending upon whether a gain is realized or a loss is sustained. Therefore, certain matters involved in the determination of gain or loss must be examined.

Determination of Gain or Loss

Here, as elsewhere in the law, whether there is a gain or loss depends upon whether the net proceeds received on the conversion exceed or are less than the taxpayer's adjusted basis for the property

21. INT. REV. CODE OF 1954, § 1031(d); Treas. Reg. § 1.1031(d)-1(b) (1956) and *Example.*

22. See discussion of basis allocation p. 163.

23. INT. REV. CODE OF 1954, § 1031(d); Treas. Reg. § 1.1031(d)-1(d) (1956). This results in deferring the nonrecognized gain or loss to the ultimate disposition of the "like kind" property.

24. In Rev. Rul. 59-102, 1959 INT. REV. BULL. NO. 13, at 20, the Commissioner recognizes, however, that the "suddenness" test for casualty losses under § 165 is not required for involuntary conversions through destruction.

25. It is not necessary that the taxpayer be divested of complete ownership. Involuntary conveyance of the rights representing substantially all the value of the property, *e.g.,* an easement in perpetuity, is sufficient. Rev. Rul. 575, 1954-2 CUM. BULL. 145; O.D. 1072, 5 CUM. BULL. 89 (1921). In certain circumstances, disposition of the damaged residue may also be an involuntary conversion. In Harry G. Masser, 30 T.C. 741 (1958), sale of one parcel under threat of condemnation made impractical the operation of the remaining parcel. Sale of the latter was also held to be an involuntary conversion. The question in each case is whether the property condemned and that sold comprise one economic unit. Rev. Rul. 59-361, 1959 INT. REV. BULL. NO. 45, at 9, *revoking* Rev. Rul. 117, 1957-1 CUM. BULL. 261.

converted. Accordingly, there are involved such determinations as allocation of the proceeds received (*e.g.*, to eliminate from the proceeds such ordinary income items as may properly receive separate treatment and to apportion the remainder among the several properties involved), allocation of the basis for the property (*e.g.*, between the portion converted and the residue), and the treatment of expenses of the conversion (*e.g.*, whether deductible from other income or simply as a reduction in computing the net proceeds).

Allocation of Proceeds and Basis

Frequently, a fire or other conversion by destruction, or a condemnation, will involve more than one property. In such cases, the taxpayer is, at the outset, met with the question of whether the gain or loss may properly be computed separately for each property involved. It seems clear that where separate properties are involved, gain or loss must be separately computed upon receipt of the insurance proceeds.[26] Similarly, if more than one property is affected by a condemnation proceeding, gain or loss may properly be computed for each. The situation here should be no different from that encountered when a portion of several properties is sold, whether under threat or imminence of condemnation or not.[27]

The proceeds realized upon an involuntary conversion will sometimes include such elements as interest for delay in payment, rent for interim use of the property condemned, and loss of profits. Where these are identified as such in the award, they are clearly taxable as ordinary income and must be excluded from the proceeds of the conversion.[28] Where the proceeds are not so identified, however, the law seems clear that no part of the lump sum may be treated as in-

26. In International Boiler Works Co., 3 B.T.A. 283 (1926), *acq.*, V-2 CUM. BULL. 2 (1926), materials, machinery, and buildings were insured under separate policies. It was held that a fire *loss* on the buildings was deductible and that the taxpayer had a nontaxable *gain* on the conversion of materials and machinery. This decision also indicates, by dictum, that the same rule applies where separate assets of the same class (*e.g.*, buildings) are separately insured. This is certainly true where this occurs under separate insurance policies, and should be true where there is a single policy covering several assets of the same class. *Cf.* Ticket Office Equip. Co., 20 T.C. 272 (1953), *acq. on this issue*, 1953-2 CUM. BULL. 6, *aff'd on other issues*, 213 F.2d 318 (2d Cir. 1954). But see Massillon-Cleveland-Akron Sign Co., 15 T.C. 79 (1950), *acq.*, 1950-2 CUM. BULL. 3. In some cases the result may depend upon whether the proceeds are separated as among the several properties in the insurance settlement. *Cf.* Lehman Co. of America, 17 T.C. 422 (1951), *acq.*, 1952-1 CUM. BULL. 3. Unfortunately, the regulations here, as in so many instances, are completely silent.

27. See note 31 *infra* and discussion p. 163.

28. Kieselbach v. Commissioner, 317 U.S. 399 (1943) (interest portion of award stipulated by the parties); International Boiler Works Co., 3 B.T.A. 283 (1926) (proceeds of use and occupancy insurance). The Commissioner applies the same rule where only use and occupancy of the property is taken from the owner by condemnation. Rev. Rul. 38, 1953-1 CUM. BULL. 16; Rev. Rul. 261, 1957-1 CUM. BULL. 262. But see Guy L. Waggoner, 15 T.C. 496 (1950) (sums paid by condemning authority for damages during occupancy). Such cases should be distinguished from situations where a lessee's leasehold interest is condemned, and an involuntary conversion results. I.T. 3793, 1946-1 CUM. BULL. 96.

terest, rent, or the like.[29] Therefore, where, as in most instances, it is advantageous that none of the proceeds be treated as ordinary income, it is important that the practitioner avoid, wherever possible, any reference to such items in the contract, award, or insurance settlement.

There is evidence of a similar reluctance on the part of the courts to permit lump sum proceeds received upon condemnation, or upon sale under threat of condemnation, to be treated in part as damages to the residue of the property even where it can be shown that such an element was included in arriving at the lump sum.[30] Recent rulings of the Commissioner indicate a strict adherence to this principle.[31] Accordingly, where, as in many instances, it is to the taxpayer's advantage to treat part of the award as damages to the residue, it is important that the practitioner make certain that the contract or court decree contains an express designation of the portion awarded as such damages.

Separation of the award as between compensation for the land taken and damages to the residue can have important consequences to the taxpayer. In computing gain or loss where only part of the property is taken, the cost or other basis of the property must be allocated between the portion of the property taken and the residue.[32] Where, as frequently occurs, the portion actually taken is a relatively small segment of the property, the basis properly allocable to such portion may be minimal, with resultant large gain on the taking. On the other hand, any amount properly identified as damages to the residue must first be absorbed against the basis of the residue,[33] and there is no gain except, and to the extent that, the damages exceed such basis. Where the residue consists solely of unimproved land, reduction in its basis has no immediate tax consequences.[34] Gain or

29. Estate of Jacob Resler, 17 T.C. 1085 (1952), *acq.*, 1952-1 CUM. BULL. 3 (lump sum received on sale under threat of condemnation not taxable in part as rent); Claude B. Kendall, 31 T.C. 549 (1958), *acq.*, 1959 INT. REV. BULL. No. 13, at 7 (lump sum received on sale under threat of condemnation not taxable in part as compensation for lost profits). See also O. N. Bymaster, 20 T.C. 649 (1953).

30. Latham v. United States, 178 F.2d 994 (2d Cir. 1950) (contract); Greene v. United States, 173 F. Supp. 868 (N.D. Ill. 1959) (contract); Ridge Road Inv. Corp., 13 P-H Tax Ct. Mem. 231 (1944) (contract); Estate of Edgar A. Appleby, 41 B.T.A. 18 (1940), *aff'd on other issues,* 123 F.2d 700 (3d Cir. 1941) (court decree); Langley Collyer, 38 B.T.A. 106 (1938) (court decree); Marshall C. Allaben, 35 B.T.A. 327 (1937) (contract); George A. Spencer, 33 B.T.A. 936 (1936) (deed included waiver of damages).

31. Rev. Rul. 575, 1954-2 CUM. BULL. 145; Rev. Rul. 59-173, 1959 INT. REV. BULL. No. 22, at 18.

32. See discussion p. 163 regarding basis allocation generally. Treas. Reg. § 1.61-6(a) (1957) and *Example* require cost to be "equitably apportioned" where part of a larger property is sold.

33. Pioneer Real Estate Co., 47 B.T.A. 886 (1942), *modified on another issue,* 12 P-H Tax Ct. Mem. 171 (1943), *acq.*, 1943 CUM. BULL. 18; G.C.M. 23698, 1943 CUM. BULL. 340; Rev. Rul. 271, 1953-2 CUM. BULL. 36; Rev. Rul. 575, 1954-2 CUM. BULL. 145.

34. Where the damaged residue consists of more than one tract of land, the award for damages must be allocated to each, probably in accordance with their relative fair market values in the absence of better evidence. But see O. N. Bymaster, 20 T.C. 649 (1953).

loss on the property is to that extent deferred until the residue is itself disposed of in a taxable transaction. However, where the residue damaged consists of both land and depreciable improvements, or of the latter only, the amount awarded as damages may have to be allocated partly to the improvements, thereby reducing their depreciable basis.[35] Generally, this is a result to be avoided if at all possible.

In some instances the property will be condemned in connection with an improvement which benefits the residue of the property and for which it is assessed. The special assessment may be a substantial portion of the award and sometimes will, in fact, exceed it. In such cases, if the special assessment were treated as a transaction separate from the condemnation, the taxpayer could be taxed on a condemnation gain and be deemed to have paid a nondeductible assessment,[36] even though the two were in fact offset in the condemnation award. After some uncertainty,[37] the rule is now definitely settled that such cases will be treated as a single transaction and the special assessment netted against the award.[38] Thus, only if the award for the land taken plus the severance damages exceed the special assessment is there any amount realized on the condemnation.[39] The liberality of this rule is somewhat startling in view of the strictness of the Commissioner's position on other issues in this field.

Treatment of Expenses

In the area of involuntary conversion, as in other dispositions, the taxpayer faces the problem of determining whether particular expenditures are to be treated as ordinary deductions against other income,[40] or simply as a charge against the proceeds of the conversion. Clearly, such items as temporary building repairs prior to replace-

35. But see State *ex rel.* Merrell v. Pittman, 44 Ohio App. 107, 184 N.E. 15 (1932), holding that, under the Ohio condemnation statutes, it is improper for the jury to break down the amount awarded for damage to the residue. *Cf.* Demack Drug & Medical Co., 7 P-H Tax Ct. Mem. 534 (1938). If allocation between land and improvements is required, it would appear that, in the absence of better evidence, an allocation based upon their relative fair market values would be proper here, as in other areas where such an allocation is required. See discussion p. 164.

36. Under INT. REV. CODE OF 1954, § 164(b)(5) discussed p. 161.

37. G.C.M. 12632, XIII-1 CUM. BULL. 104 (1934).

38. Central & Pac. Inv. Corp. v. Commissioner, 92 F.2d 88 (9th Cir. 1937); Christian Ganahl Co. v. Commissioner, 91 F.2d 343 (9th Cir. 1937), *cert. denied*, 302 U.S. 748 (1937); Wolf v. Commissioner, 77 F.2d 455 (9th Cir. 1935) (special assessment exceeded award); Income Syndicate, Inc., 37 B.T.A. 926 (1938), *acq.*, 1938-2 CUM. BULL. 17; G.C.M. 20322, 1938-2 CUM. BULL. 167; Paladium Amusement Co., 37 B.T.A. 149 (1938), *acq.*, 1938-2 CUM. BULL. 24; Calvin C. Green, 37 B.T.A. 25 (1938), *acq.*, 1938-2 CUM. BULL. 13; *cf.* Carrano v. Commissioner, 70 F.2d 319 (2d Cir. 1934).

39. Treas. Reg. § 1.1033(a)-2(c)(10) (1957) now provide that if the government retains out of the award funds to satisfy special assessments against the residue for benefits accruing in connection with the condemnation, the retained amount is to be subtracted from the gross award.

40. *E.g.*, as ordinary and necessary expenses under INT. REV. CODE OF 1954, §§ 162, 212.

ment of the building, removal of damaged property and cleanup work, installation of temporary enclosures and electrical work, repainting, and other items of a temporary and nonrecurring nature are currently deductible expenses.[41] Similarly, the cost of hiring attorneys and adjusters to collect the insurance claim is deductible as an ordinary and necessary expense where the taxpayer suffers a loss.[42] Where the involuntary conversion results in a gain, however, the attorneys' fees incurred in obtaining the proceeds are not so deductible, but are netted against the proceeds.[43] The rule here parallels that followed for attorneys' fees and other expenses incurred upon sale or exchange generally.[44] In the following discussion, therefore, it will be understood that the term "proceeds" means "net proceeds" after subtracting such fees and expenses.

Special Tax Consequences of Involuntary Gains and Losses

Generally, the special advantages of capital gain treatment are not available unless there is (1) a "sale or exchange" of (2) a "capital asset" which has been held for more than six months.[45] The correlative disadvantages of capital loss treatment do not generally accrue in the absence of these requirements.[46] Both of these requirements are substantially modified in the area of involuntary conversions.

The sale of property under threat or imminence of condemnation is still a "sale." Conversion of property upon condemnation is a sale or an exchange, depending upon whether money or other property is received therefor. But the receipt of insurance proceeds upon destruction of property in whole or in part is neither a sale nor an exchange.[47] Thus, in the absence of statutory fiat, gains and losses in the latter case would be ordinary income or ordinary loss, even though the property involved were a "capital asset." And even in cases where the involuntary conversion was a sale or exchange, whether it resulted in ordinary or capital gain or loss would depend upon its being a "capital asset."

The code[48] discards these distinctions and provides that if there is

41. Ticket Office Equip. Co., 20 T.C. 272 (1953), *acq. on this issue,* 1953-2 CUM. BULL. 6, *aff'd on other issues,* 213 F.2d 318 (2d Cir. 1954).

42. *Ibid.*

43. Columbus Die Tool & Mach. Co., 21 P-H Tax Ct. Mem. 940 (1952). But attorneys' fees incurred in successfully resisting a condemnation are currently deductible. C. B. Reakirt, 29 B.T.A. 1296 (1934), *aff'd per curiam,* 84 F.2d 996 (6th Cir. 1936).

44. See discussion p. 223.

45. INT. REV. CODE OF 1954, §§ 1201-02, 1221-22.

46. INT. REV. CODE OF 1954, §§ 1211-12.

47. Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247 (1941) ("'exchange' implies reciprocal transfers of capital assets").

48. INT. REV. CODE OF 1954, § 1231(a).

a *net* recognized gain from (1) sales or exchanges of "property used in the trade or business," and (2) involuntary conversions of such property and of capital assets held for more than six months (after netting losses on such transactions for that year), all of the gains and losses described "shall be considered" as long-term capital gains and losses. Put another way, if the only transaction of the type described which occurred during the year is an involuntary conversion of "property used in the trade or business," long term capital gain treatment, with a maximum tax of twenty-five per cent, is assured. On the other hand, if such gains do not exceed such losses, then the gains and losses "shall not be considered as gains and losses from sales or exchanges of capital assets." This effectively provides a one-way street which can benefit, but can never harm, the taxpayer. If a net gain is involved, the taxpayer is assured of long-term capital gain treatment thereon. If a net loss is involved, the taxpayer obtains ordinary loss deductions for the loss transactions[49] and long-term capital gains treatment for the gain transactions.

It should be noted that this special treatment is limited to (a) sales, exchanges, and involuntary conversions of "property used in the trade or business," and (b) involuntary conversions of "capital assets." Depreciable property and real property used in trade or business which has been held for more than six months are included, but property held primarily for sale to customers (*e.g.*, by a dealer in real estate) is not included in this special treatment.[50] Thus, with the exception of property held for sale, this special treatment will apply to practically every kind of real estate and its appurtenant personal property.

Nonrecognition of Gain

Having examined how gain or loss is determined upon involuntary conversions, and having observed that, generally, the taxpayer is assured of capital gain treatment on gains, and of ordinary deduction treatment on losses, the next matter for consideration is the method by which any such gain can be nonrecognized and deferred. No provision is made in the code for deferral of a loss on involuntary conversion.[51]

Circumstances of Nonrecognition Generally

If property is involuntarily converted into other property which

49. Ordinary loss treatment is given to all involuntary conversion losses, including those which would otherwise be capital losses only, *e.g.*, sale of a capital asset under threat or imminence of condemnation. Treas. Reg. § 1.1231-1(g) (1959) *Example 2.*

50. INT. REV. CODE OF 1954, § 1231(b). Subject to certain qualifications, this also includes timber, coal, livestock, and unharvested crops in the classes of property entitled to the benefits.

51. Losses, however, are recognized or not recognized and allowed or disallowed without regard to INT. REV. CODE OF 1954, § 1033. Treas. Reg. § 1.1033(a)-1(a) (1958).

qualifies as replacement property, no gain is recognized.[52] Thus, if, under threat or imminence of condemnation, the taxpayer deeds to the state unimproved land having a low cost basis in exchange for the state's deeding to him other unimproved land having a high value, no gain is recognized to the taxpayer. In such a case, the taxpayer has no election. Nonrecognition of gain is mandatory where qualified replacement property is received in kind upon involuntary conversion.[53] However, if property is involuntarily converted into money, or into nonqualified property, or both, then the gain is not recognized if the taxpayer (a) within the time permitted purchases qualified replacement property at a cost at least equal to the proceeds and (b) makes the required election.[54] It should be emphasized that even if the taxpayer meets the replacement requirement, he is still at liberty to pay the tax rather than to defer it.[55]

Direct conversion into other property, whether qualified or nonqualified, is obviously rare. Generally the conversion will be into money. Therefore, in the following discussion, reference will be principally to the latter case.

Replacement of the Converted Property

Three types of property qualify as replacement property into which the property can be converted directly or, where money or nonqualified property is received, which qualify for purchase as replacement property: (1) property which is "similar or related in service or use" to that converted;[56] (2) stock representing at least eighty per cent control of a corporation which owns such property;[57] and (3) property of a "like kind" where real property is held for productive use in trade or business, or for investment.[58] The first two of these are of general application. The third is limited to real property[59] which was involuntarily converted after December 31, 1957.[60]

52. INT. REV. CODE OF 1954, § 1033(a)(1).

53. Treas. Reg. §§ 1.1033(a)-1(a) (1958), 1.1033(a)-2(b) (1957).

54. INT. REV. CODE OF 1954, § 1033(a)(3). Different rules apply where the involuntary conversion occurred prior to January 1, 1951. INT. REV. CODE OF 1954, § 1033(a)(2); Treas. Reg. § 1.1033(a)-3 (1957). The present discussion is limited to cases where the involuntary conversion occurred after December 31, 1950.

55. In some circumstances, it will be to the taxpayer's advantage not to make the election. See discussion p. 220 *infra*.

56. INT. REV. CODE OF 1954, § 1033(a)(3)(A).

57. *Ibid.* INT. REV. CODE OF 1954, § 1033(a)(2) defines "control" for this purpose to mean ownership of stock possessing at least 80% of total combined voting power of all classes of stock entitled to vote, plus at least 80% of the total number of non-voting shares.

58. Property held for sale is excluded under INT. REV. CODE OF 1954, § 1033(g)(1).

59. It will be noted also that purchase of 80% control in a corporation owning "like kind" property does not satisfy the statute. INT. REV. CODE OF 1954, § 1033(g)(2)(A). It is difficult to understand why Congress limited this provision in view of its general desire to bring the rules of involuntary conversion into line with the more liberal rules of voluntary exchange under § 1031. See S. REP. NO. 1983, 85th Cong., 2d Sess. 72-73 (1958).

60. INT. REV. CODE OF 1954, § 1033(g)(2)(B).

The phrase "similar or related in service or use" involves a comparison of the function and purpose of the property converted with that of the property acquired, and a comparison of the character of the service or use of the two properties, rather than a comparison of the kind of properties. Generally, the phrase has received a relatively narrow interpretation by the courts and the Commissioner.[61] Even improved land has been held not to qualify as replacement for improved land where there were differences in the use to which they were put.[62] Recognizing the basic unfairness in imposing different and stricter tests for nonrecognition of gain in involuntary transactions than are required for voluntary exchanges, Congress has recently amended the law to permit "like kind" property to qualify here.[63] Congress clearly intends that the phrase "like kind" should receive the same interpretation in the area of involuntary conversion as it has received in the area of voluntary exchanges of property.[64]

Finally, it should be observed that there is no requirement that the replacement property consist of the same proportion of the several types of assets as the property converted. For example, if the property destroyed by fire consisted of buildings, machinery, and equipment in certain proportions, the replacement property may qualify as "similar or related in service or use" to the property converted, even though the buildings, machinery, and equipment included are in different proportions.[65] In condemnations and sales under threat or imminence of condemnation, this problem will probably no longer arise since "like kind" permits even the conversion of improved into unimproved real estate, or vice versa.[66]

In addition to meeting these requirements as to the *type* of replacement property, the statute requires that the replacement property be acquired in a certain *manner* and within a specified period of

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61. Denny L. Collins, 29 T.C. 670 (1958) (improved land used as poultry farm dissimilar to improved land used for rental and gasoline station); Lynchburg Nat'l Bank & Trust Co., 20 T.C. 670 (1953), *aff'd*, 208 F.2d 757 (4th Cir. 1953) (building rented to tenants held dissimilar to building occupied as bank quarters); L.O. 914, 1 CUM. BULL. 77 (1919) (tug dissimilar to barges); I.T. 1617, II-1 CUM. BULL. 119 (1921) (unimproved land can be converted only into unimproved land suitable for the same use); Treas. Reg. §§ 1.1033(a)-2(c)(9)(i), (iii) (1957). See Stewart Bros. v. Commissioner, 261 F.2d 580 (4th Cir. 1958), *reversing* 29 T.C. 372 (1957); Gaynor News Co., 22 T.C. 1172 (1954); *cf.* Rev. Rul. 347, 1956-2 CUM. BULL. 517.

62. Denny L. Collins, *supra* note 61; Lynchburg Nat'l Bank & Trust Co., *supra* note 61. If, instead of involuntary conversion, these had involved a voluntary exchange, they would have been nontaxable as "like kind" exchanges. See cases cited in notes 9-11 *supra.*

63. INT. REV. CODE OF 1954, § 1033(g), added by Technical Amendments Act of 1958 § 46(a), 72 Stat. 1606.

64. S. REP. NO. 1983, 85th Cong., 2d Sess. 72-73 (1958). See discussion of "like kind" exchanges p. 207 *supra.*

65. Ticket Office Equip. Co., 20 T.C. 272 (1953), *acq. on this issue,* 1953-2 CUM. BULL. 6, *aff'd on another issue,* 213 F.2d 318 (2d Cir. 1954); Massillon-Cleveland-Akron Sign Co., 20 T.C. 79 (1950), *acq.,* 1950-2 CUM. BULL. 3. This, of course, assumes that there is a single conversion. See discussion p. 211 *supra.*

66. See discussion p. 208 *supra.*

time. Only where the replacement property is acquired by purchase does it qualify.[67] Acquisition in a nontaxable transaction is excluded. It should be emphasized that the proceeds of the involuntary conversion need not be traced into the replacement property. It is sufficient that the taxpayer purchases replacement property. The source of funds used for this purpose is immaterial. It may be other available funds of the taxpayer, or even borrowed funds, including obligations assumed, or subject to which the property was purchased. Indeed, where the property is converted into nonqualified property, the replacement requirement could not otherwise be met.

The replacement property must be purchased after the earliest date of threat or imminence of condemnation and before the end of the taxable year next succeeding the taxable year during which the conversion occurs.[68] Thus, the taxpayer will always have at least one full year within which to purchase the replacement property. Frequently, he will have a considerably longer period. It will be noted that in some cases the replacement property can qualify even though purchased in advance of the involuntary conversion. Thus, after condemnation has been threatened or has become imminent, the taxpayer may purchase the qualified replacement property even though this antedates the taking or involuntary sale. The only additional requirement in such cases is that the replacement property still be owned by the taxpayer at the time the involuntary conversion itself occurs.[69]

Replacement Costing Less Than the Proceeds

Where, within the time period described above, the taxpayer purchases qualified replacement property at a cost at least equal to the net proceeds of the conversion, then the taxpayer may elect to defer the entire gain. But if the qualified replacement property purchased within the period costs less than the net proceeds, then the taxpayer will be taxable on either (1) the amount of the gain, or (2) the amount by which the cost of replacement falls short of the net proceeds, whichever amount is the lesser.[70] The balance of the gain, if any, may at the election of the taxpayer be deferred. To illustrate, assume that the taxpayer receives $15,000 on condemnation of land which cost him $10,000, thus realizing a profit of $5,000. If, within the required period, he purchases other land at a cost of $9,000, the entire $5,000 gain will be recognized. But if the other land cost him $14,000, only $1,000 of the gain will be recognized, provided that he elects to have the gain deferred.

67. INT. REV. CODE OF 1954, § 1033(a)(3)(A)(ii).

68. INT. REV. CODE OF 1954, § 1033(a)(3)(B). But this period can be extended by the District Director upon a proper showing. Treas. Reg. § 1.1033(a)-2(c)(3) (1957).

69. INT. REV. CODE OF 1954, § 1033(a)(3)(A)(i).

70. INT. REV. CODE OF 1954, § 1033(a)(3)(A).

Curiously, a different rule has been indicated for damages awarded to the residue upon condemnation. One ruling by the Commissioner[71] is that where the qualified replacement property is purchased at a cost less than the damages awarded, (a) only the unexpended balance need be applied against the basis of the residue, and (b) there is no gain except to the extent that the unexpended balance exceeds such basis. This, in effect, permits the deduction of *both* the cost of the replacement *and* the basis of the property in determining the amount of gain. As applied to the illustration above, the taxpayer would have no gain even if the replacement property cost only $9,000, since that plus the $10,000 cost exceeds the $15,000 award. This position seems to be clearly wrong under the statute. Therefore, it is doubtful whether this ruling may be relied upon for this point.[72]

Election to Defer Taxation of the Gain

Even though the taxpayer purchases qualified replacement property, he may, if he so desires, have the entire gain recognized simply by reporting the gain on his return for the year during which it was realized.[73] On the other hand, if he desires to defer the tax, he should so elect by including in the return for the year or years of gain a statement of the details of the conversion and of the replacement as well, if it has then been made.[74] A separate election must be made for each involuntary conversion.[75]

If, at the time the taxpayer makes the election to defer the tax, the replacement property has not been purchased, the taxpayer must report the details of the replacement in the return for the year during which it occurs.[76] If the taxpayer elects to pay the tax and later changes his mind, the election to defer the tax may be made by filing a claim for refund. If he elects to defer the tax but qualified replacement property is not purchased within the time permitted, or is later purchased at a lesser cost than was anticipated when the election was made, or if a later decision is made not to replace, an amended return

71. Rev. Rul. 271, 1953-2 CUM. BULL. 36.

72. The same ruling correctly holds that any gain realized from an award for damage to the residue is subject to replacement and election under INT. REV. CODE OF 1954, § 1033. The latter point has been reaffirmed in Rev. Rul. 575, 1954-2 CUM. BULL. 145.

73. Treas. Reg. § 1.1033(a)-2(c)(2) (1957).

74. *Ibid.* The same regulation also recognizes that a simple failure to report the gain on the return is also effective as an election to defer the tax.

75. For example, the taxpayer may elect to be taxed on the gain realized upon condemnation of one parcel and may elect to defer gain on another parcel, or may elect to be taxed on the gain realized upon the land condemned and may elect to defer gain resulting from the award for damages to the residue, or vice versa. But see discussion p. 211 *supra* for separation of the award in such cases.

76. When the return for the later year is filed with a different District Director, the required statement should be filed with the District Director in whose office the return for the year of gain was filed. Treas. Reg. § 1.1033(a)-2(c)(5) (1957).

should be filed for the year during which the gain was realized.[77] Failure to file an amended return in the one case, or failure to notify of the replacement in the other, results in keeping open the statute of limitations on assessment of deficiencies.[78]

Factors to be Considered in Deciding Whether to Elect

Where business necessity requires the taxpayer to replace the converted property, and requires that the taxpayer use the proceeds undiminished by a capital gains tax of twenty-five per cent, the taxpayer has no real choice. He should elect to defer the tax. In all other cases, the question of whether the election should be made requires careful consideration. Generally, there are two factors to be weighed:

(a) Where the taxpayer is a closely-held corporation, the decision whether to replace the property and to make the election may be influenced by the effect which the alternative courses of action may have upon the corporation's earnings and profits. If qualified replacement property is purchased and the corporation elects nonrecognition of the gain, the earnings and profits account remains unchanged.[79] But if it elects to pay, rather than to defer the tax, the recognized gain on the conversion increases the current earnings and, unless distributed as dividends, will increase accumulated earnings and profits.[80] Particularly where the proceeds are not reinvested in productive facilities (whether or not qualified replacement property), this course may increase the corporation's exposure to the penalty tax.[81]

(b) In the case of all taxpayers, it should be recognized that if the election is made to defer the tax, the basis of the replacement property is its cost minus the amount of gain not recognized on the conversion.[82] This is unimportant if the entire award is invested in nondepreciable property, such as unimproved land, which is to be held for an indefinite period. In such a case, the net effect is merely to defer taxation of the gain from the current year to the later year

77. The regulations do not state whether after electing to defer the gain, the taxpayer, having purchased qualified replacement property within the prescribed time, can change his election. However, there is no apparent reason why the taxpayer should not be entitled to change his mind in such circumstances.

78. INT. REV. CODE OF 1954, § 1033(a)(3)(C) provides that deficiencies relating to gain on involuntary conversion may be assessed within three years from the date the taxpayer gives notice of the replacement, or of an intention not to replace. For the statute of limitations on assessment of other deficiencies attributable to an election under this section, see INT. REV. CODE OF 1954, § 1033(a)(3)(D).

79. INT. REV. CODE OF 1954, § 312(f)(1).

80. *Ibid.*

81. Under INT. REV. CODE OF 1954, §§ 531-37.

82. INT. REV. CODE OF 1954, § 1033(c). The same section also provides that if more than one replacement property is purchased, the total basis shall be allocated among them "in proportion to their respective *costs*." (Emphasis added.)

when the replacement property is itself sold at a gain. If the replacement property is later sold at a loss, the effect of the election is to reduce the loss below what it otherwise would have been. However, if the replacement property is wholly or partly depreciable property, such as buildings, equipment, or the like, the election to defer the tax will result in a low basis for the replacement property, with smaller depreciation deductions than would otherwise obtain. In such a case, the net effect of the election is to avoid immediate taxation on the gain, but with a correlative loss of depreciation deductions. The general result is that a present benefit is obtained equal to twenty-five per cent of the gain, but at a cost equal to fifty-two per cent of the net proceeds after capital gains tax, assuming that the corporate tax rates remain at the present level during the useful life of the depreciable property purchased. This also assumes in the one case that the entire award, and in the other case that the entire net proceeds after tax, are invested solely in depreciable property. To the extent that the replacement is in nondepreciable property, this disadvantage of making the election is, of course, diminished. However, it will frequently be found to be to the taxpayer's benefit to pay the capital gains tax immediately rather than to elect to defer it.